

of this section, the group of activities must constitute the carrying on of a trade or business under section 162(a) (determined as though the activities were conducted by an individual).

(ii) *Trading and investment partnerships*—(A) *In general.* The activity of acquiring, holding, or disposing of financial instruments constitutes a trade or business for purposes of this paragraph (b)(8) if and only if the activity is conducted by an entity registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

(B) *Financial instruments.* For purposes of paragraph (b)(8)(ii) of this section, financial instruments include stock in corporations; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, stock, securities, currencies, or commodities, including options, forward or futures contracts, or short positions; or any similar financial instrument.

(iii) *Examples.* The following examples illustrate the provisions of paragraph (b)(8) of this section:

*Example 1.* Corporation Y owns, manages, and derives rental income from an office building and also owns vacant land that may be subject to environmental liabilities. Corporation Y contributes the land subject to the environmental liabilities to PRS in a transaction governed by section 721(a). PRS plans to develop the land as a landfill. The contribution of the vacant land does not constitute the contribution of a trade or business because Corporation Y did not conduct any significant business or development activities with respect to the land prior to the contribution.

*Example 2.* For the past 5 years, Corporation X has owned and operated gas stations in City A, City B, and City C. Corporation X transfers all of the assets associated with the operation of the gas station in City A to PRS for interests in PRS and the assumption by PRS of the § 1.752-7 liabilities associated with that gas station. PRS continues to operate the gas station in City A after the contribution. The contribution of the gas station to PRS constitutes the contribution of a trade or business.

*Example 3.* For the past 7 years, Corporation Z has engaged in the manufacture and sale of household products. Throughout this period, Corporation Z has maintained a research department for use in connection with its manufacturing activities. The research department has 10 employees actively engaged in the development of new products. Corporation Z contributes the research department to PRS in exchange for a PRS interest and the assumption by PRS of pension liabilities with respect to the

employees of the research department. PRS continues the research operations on a contractual basis with several businesses, including Corporation Z. The contribution of the research operations to PRS constitutes a contribution of a trade or business.

(9) *Adjusted value.* The adjusted value of a partner's interest in a partnership is the fair market value of that interest increased by the partner's share of partnership liabilities under “1.752-1 through 1.752-5.

(c) *Application of section 704(c) to assumed § 1.752-7 liabilities*—(1) *In general.* Any § 1.752-7 liability assumed by a partnership in a § 1.752-7 liability transfer is treated under section 704(c) principles as having a built-in loss equal to the amount of the § 1.752-7 liability as of the date of the partnership's assumption of the § 1.752-7 liability. Thus, items of deduction or loss with respect to the § 1.752-7 liability, if any, must be allocated, first, to the § 1.752-7 liability partner to the extent of the built-in loss. Deductions or losses with respect to the § 1.752-7 liability that exceed the built-in loss are shared among the partners in accordance with section 704(b) and the regulations thereunder.

(2) *Example.* The following example illustrates the provisions of this paragraph (c):

*Example*—(i) *Facts.* In 2004, A, B, and C form partnership PRS. A contributes Property 1 with a fair market value and basis of \$400X, subject to a § 1.752-7 liability of \$100X, for a 25% interest in PRS. B contributes \$300X cash for a 25% interest in PRS, and C contributes \$600X cash for a 50% interest in PRS. Assume that the partnership complies with the substantial economic effect safe harbor of § 1.704-1(b)(2). Under § 1.704-1(b)(2)(iv)(b), A's capital account is credited with \$300X (the fair market value of Property 1, \$400X, less the § 1.752-7 liability assumed by PRS, \$100X). In 2005, PRS earns \$200X of income and uses it to satisfy the § 1.752-7 liability. Assume that the cost to PRS of satisfying the § 1.752-7 liability is deductible by PRS. The \$200X of partnership income is allocated according to the partnership agreement, \$50X to A, \$50X to B, and \$100X to C.

ii. *Analysis.* Pursuant to paragraph (c) of this section, \$100X of the deduction attributable to the economic performance of the § 1.752-7 liability is specially allocated to A, the § 1.752-7 liability partner, under section 704(c)(1)(A) and the regulations thereunder. No book item corresponds to this tax allocation. The remaining \$100X of deduction attributable to economic performance of the § 1.752-7 liability is allocated, for both book and tax purposes, according to the partnership agreement, \$25X to A, \$25X to B, and \$50X to C. If the partnership, instead, satisfied the § 1.752-7 liability over a number of years, the first \$100X of deduction with respect to the § 1.752-7 liability would be allocated to A,

the § 1.752-7 liability partner, before any deduction with respect to the § 1.752-7 liability would be allocated to the other partners. For example, if PRS were to satisfy \$50X of the § 1.752-7 liability at a time when PRS reasonably believed that it would cost \$200X to satisfy the § 1.752-7 liability in full, the \$50X deduction with respect to the § 1.752-7 liability would be allocated to A for tax purposes only. No deduction would arise for book purposes. If PRS later paid a further \$100X in satisfaction of the § 1.752-7 liability, \$50X of the deduction with respect to the § 1.752-7 liability would be allocated, solely for tax purposes, to A and the remaining \$50X would be allocated, for both book and tax purposes, according to the partnership agreement.

(d) *Special rules for sales of partnership interests, distributions of partnership assets, and assumptions of the § 1.752-7 liability after a § 1.752-7 liability transfer*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, paragraphs (e), (f), and (g) of this section apply to certain partnership transactions occurring after a § 1.752-7 liability transfer.

(2) *Exceptions*—(i) *In general.* Paragraphs (e), (f), and (g) of this section do not apply—

(A) If the partnership assumes the § 1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business after the contribution (for the definition of a trade or business see paragraph (b)(8) of this section); or

(B) If, immediately before the testing date, the amount of the remaining built-in loss with respect to all § 1.752-7 liabilities assumed by the partnership (other than § 1.752-7 liabilities assumed by the partnership with an associated trade or business) in one or more § 1.752-7 liability transfers is less than the lesser of 10% of the gross value of partnership assets or \$1,000,000.

(ii) *Examples.* The following examples illustrate the principles of this paragraph (d)(2):

*Example 1.* For the past 5 years, Corporation X, a C corporation, has been engaged in Business A and Business B. In 2004, Corporation X contributes Business A, in a transaction governed by section 721(a), to PRS in exchange for a PRS interest and the assumption by PRS of pension liabilities with respect to the employees engaged in Business A. PRS plans to carry on Business A after the contribution. Because PRS has assumed the pension liabilities as part of a contribution to PRS of the trade or business with which the liabilities are associated, paragraphs (e), (f), and (g) of this section do not apply to any transaction occurring after the § 1.752-7 liability transfer.

*Example 2*—(i) *Facts.* The facts are the same as in Example 1, except that PRS also